

1941

# Combined statement of income and earned surplus; Accounting Research Bulletin, no. 08

American Institute of Certified Public Accountants. Committee on Accounting Procedure

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## Recommended Citation

American Institute of Certified Public Accountants. Committee on Accounting Procedure, "Combined statement of income and earned surplus; Accounting Research Bulletin, no. 08" (1941). *American Institute of Accountants*. 349.  
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# Accounting Research BULLETINS

February 1941

No. 8

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Issued by the  
Committee on Accounting Procedure,  
American Institute of Accountants,  
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## Combined Statement of Income and Earned Surplus

IN RESEARCH BULLETIN No. 1 the committee called attention to the "increased recognition of the significance of the income statement" and the resulting "tendency to regard the balance-sheet as the connecting link between successive income statements and as the vehicle for the distribution of charges and credits between them." This led to a suggestion that the committee should give consideration to the general form of the income statement, with particular reference to the question of the influence of form upon effective presentation in the light of the enlarged conception of the functions of the statement.

The term "income statement" will be used throughout this memorandum though the committee recognizes that in some cases the term "profit and loss" is used instead of "income," and "account" instead of "statement." These differences in usage are under consideration by the committee on terminology.

The committee has noted, from examination of the published statements of a selection of 500 corporations, a considerable tendency toward the practice of closely combining the annual income statement with the statement of earned surplus. For the year 1939 the income statement was presented as a single integrated statement, running from sales to earned-surplus balance, in 19 per cent of the cases examined. In another 32 per cent the income statement and surplus statement were shown as two related exhibits on a single page of the published report. In 32 per cent of the examples the income statement and surplus statement were shown as separate exhibits but with their close relationship emphasized by presentation on facing pages of the report. In only 17 per cent of the cases were the earned-surplus analyses shown otherwise than as incorporated with or adjacent to the current operating data. Appendix A shows a tabulation of these data for 1939 and 1938.

There are decided advantages in such combined statements, but also some disadvantages. The committee therefore feels that a useful purpose will be served if it expresses approval of the practice where it is found feasible, without recommending its general adoption; at the

same time it points out certain considerations which must be borne in mind if undesirable consequences are to be avoided.

### **Advantages of the Combined Statement**

The combined statement of income and earned surplus is designed to meet a dilemma which constantly confronts the accountant. Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital-stock transactions, be charged against income. If this principle could in practice be carried out perfectly, there would be no charges against earned surplus, except for distributions and appropriations of final net income. This is a theoretical ideal upon which all may agree, but because of conditions impossible to foresee, it often fails of attainment. From time to time charges are made against surplus which clearly affect the cumulative total of income for a series of years, even if their exclusion from the income statement of the current year is justifiable. There is danger that unless the two statements are closely connected such charges will be overlooked, or at any rate not given full weight, in any attempt on the part of the reader to compute a company's long-run income or its income-earning capacity. The combined statement of income and earned surplus minimizes the net disadvantage; while charges against earned surplus are effected within a segregated portion of the statement, yet charging them against earned surplus in this way does not completely lose them from view in any consideration of long-run income-earning capacity. In this sense the practice serves to emphasize the tentative character of the income statement.

In giving expression to these views, the committee would like to guard against misunderstanding. The committee recognizes the great importance of distinguishing between charges against income and charges against earned surplus. It does not here undertake to define proper charges against earned surplus. For purposes of this statement it simply takes cognizance of the fact that such charges are from time to time found to be a necessary though perhaps a debatable feature of accounts. It approves the current tendency to discourage such charges wherever possible.

There is a marked tendency to exaggerate the significance of the net income for a single year, and particularly the degree to which the net income can be exclusively identified with that one year. In so far as the combined form calls attention to the character of the income statement as a tentative instalment in the long-time financial results, it serves a useful purpose.

## *Combined Statement of Income and Earned Surplus*

To summarize, the combined income and earned-surplus statement serves the purpose of showing in one statement both earnings applicable to the period proper, and also modifications of earned surplus on a long-run basis. It distinguishes charges and credits of the current period from charges and credits relating to other periods by placing them in different sections of the statement; but all are comprised within a single statement.

### **Disadvantages and Limitations**

In the combined statement, the net income for the year will occur somewhere in the middle of the statement and not at the end. Such wording and arrangement should be adopted as will make this item unmistakably clear. The reader should be left in no doubt as to the point at which the net income has been determined. This figure will continue to be a most important item in the accounts; all concerned will look to the accountant to furnish the figure as exactly as he can.

While it is true that the net income amount, when expressed as "earnings per share," is often given an undue prominence and its significance is exaggerated, there nevertheless remains the responsibility for determination of net income by sound methods, and the duty to show it clearly. The adoption of the combined statement provides no excuse for less care than at present in distinguishing charges to income from charges to surplus. Any such use of this form of statement would immediately discredit it.

## **APPENDIX A**

### **CLASSIFICATION OF FORM OF PRESENTATION OF INCOME STATEMENT AND EARNED SURPLUS STATEMENT IN 500 PUBLISHED REPORTS**

	1939		1938	
	Number of Reports	Percentage of Total	Number of Reports	Percentage of Total
Combined statement of income and earned surplus.....	93	19	90	18
Separate statements of income and earned surplus on same page	160	32	158	32
Separate statements of income and earned surplus on facing pages	163	32	167	33
Other forms of presen- tation.....	84	17	85	17
Totals.....	500	100	500	100

## Accounting Research Bulletins

*The statement entitled "Combined Statement of Income and Earned Surplus" was adopted by the assenting votes of eighteen members of the committee. Two members, Messrs. Cranstoun and Seidman, dissented. One member did not vote.*

The dissenting members hold that the above statement attaches undue importance to the question of combined or separate statements. They consider that the primary question is the determination of sound principles for the separation of income and surplus charges and credits, and fear that a statement recommending one form may be interpreted as implying that that form had solved this problem, which, as all members of the committee agree, it cannot do.

### NOTES

1. *Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)*

2. *Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)*

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